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EX PARTE OR LATE FILED

Kimberly M. Kirby
Senior Manager
FCC Affairs

EX PARTE

May 1, 1997

RECEIVED

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Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, NW Room 222
Washington, DC 20554

Re: Ex Parte Presentation in CC Docket No. 96-262 and CC Docket No. 96-45

Dear Mr. Caton:

Please file the corrected version of the attached document in the above-captioned proceedings. The original document, dated April 29, 1997, is missing one page of an attachment. The enclosed version contains all of the proper documents.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(2) of the Commission's rules.

Sincerely,

Kimberly M. Kirby

Kimberly M. Kirby

Attachment

cc: Commissioner Chong
Commissioner Ness
Commissioner Quello
Regina Keeney
William Kennard
Greg Rosston
Larry Atlas
Richard Metzger
John Nakahata
Kathie Levitz
Suzanne Tetreault

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Kimberly M. Kirby
Senior Manager
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April 29, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, NW Room 222
Washington, DC 20554

Re: Ex Parte Presentation in CC Docket No. 96-262 and CC Docket No. 96-45

Dear Mr. Caton:

Please file the enclosed letter and attachments as part of the record in the above-captioned proceedings. This information is in response to a request from Chairman Hundt and therefore will not count against MCI's page limit.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Kimberly M. Kirby

Kimberly M. Kirby

Attachments

cc: Commissioner Chong
Commissioner Ness
Commissioner Quello
Regina Keeney
William Kennard
Greg Rosston
Larry Atlas
Richard Metzger
John Nakahata
Kathy Levitz
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Jonathan B. Sallet
Chief Policy Counsel

April 29, 1997

The Honorable Reed E. Hundt, Chairman
Federal Communications Commission
1919 M Street NW
Washington, DC 20554

Re: Ex Parte Presentation in CC Docket No. 96-262 and CC Docket No. 96-45

Dear Mr. Chairman:

In response to your request, we are answering three specific questions that you posed during our meeting on Monday, April 28, 1997. As you know, we remain opposed to any access charge reform plan that fails to lower the telephone rates of American consumers and businesses because, as we have explained, the current access charge system pays billions of dollars of unjustified subsidies to incumbent telephone companies. The record in this proceeding shows this beyond dispute. We also oppose any universal service proposal that fails to meet the congressional command that all subsidies for the support of affordable telephone service be made explicit immediately. Thus, while responding to your request, we want to be careful to note that we are not addressing other issues under consideration by the Federal Communications Commission ("FCC" or "Commission") whose resolution, we believe, is mandated by law.

I. What is the legal basis for resetting the productivity factor and applying it to past years?

The FCC, in its Interim Price Cap Order,[1] found that existing price cap mechanisms unreasonably shifted the balance of ratepayer and ILEC shareholder interests in favor of the ILECs. The FCC stated that a one-time reduction in ILEC Price Cap Indices was required to correct, on a prospective basis, the effects of the FCC's underestimation of LEC productivity. The FCC explained that correct specification of the productivity factor was a critical element in the balance the FCC struck between ratepayer and ILEC shareholder interests when it instituted price cap regulation.[2]

[1] In the Matter of: Price Cap Performance Review for Local Exchange Carriers, CC Docket 94-1, released April 7, 1995 ("1995 Price Cap Order").

[2] 1995 Price Cap Order at ¶¶ 245, 246.

There is a sufficient record for the FCC to adjust the productivity factor today and apply it starting from any year since 1990; a practice the Commission followed in the interim price cap order in 1995.[3] This is also consistent with recent comments submitted by the Department of Justice (see attachment) and NTIA (see attachment).

The productivity adjustment is intended to be an incentive to the ILECs to become more efficient. The current price cap, with its low productivity adjustments, provides no challenge for increased ILEC efficiency. Studies were placed in the price cap docket by AT&T, Ad Hoc and CARE which indicate true ILEC productivity is as much as 10%. The continuing trend of increased earnings demonstrate that even with the modest increases in the X factor in the interim order, the price cap is not now properly calibrated to yield a reasonable return or emulate the competitive market. Only an adjustment to the 8-10% level will yield results that accord with the purposes and objectives of the price cap procedures.

MCI recently filed an analysis of ILEC earnings as an <u>ex parte</u> presentation, which indicates the appropriate productivity adjustment would fall between 7.95% and 10.63%. This ILEC productivity analysis is filed in response to a flawed analysis submitted by USTA in Attachment 7 of its access reform comments which purports to show unbelievably low ILEC productivity.

II. <u>What mechanism should the FCC use to determine whether any reliance on market mechanisms to reduce access charges is working, and, if not, to mandate additional reductions?</u>

The end-game of any reduction in access charges should be economic cost, i.e., TELRIC-based access charges. There is abundant evidence that this will result in substantial cuts in access charges. For example, the Consumer/Business coalition proposal requires an overall cut in switched access charges of at least $10.5 billion over five years to drive access prices to TELRIC. The current price cap plan, on the other hand, forces rate cuts of, at most, inflation minus 5.3 percent, which at current expected rates of inflation would reduce access charges by about $550 million per year. At this rate, access charges would not reduced to economic cost for nineteen years.

It is important that the Commission adopt specific, enforceable mechanisms to ensure that

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[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990); <u>See</u> also1995 Price Cap Order; <u>See</u> also Ex Parte Letter dated April 23, 1997 to William F. Caton from Brad Stillman, Senior Counsel of MCI (attached); <u>See</u> also Ex Parte Letter dated April 18, 1997, to William F. Caton from Chris Frentrup, Senior Regulatory Analyst for MCI (attached); <u>See</u> also 1995 Price Cap Order at ¶ 248.

the expected access reductions are, in fact, achieved. The following two methods may be responsive to your inquiry, consistent with the conditions you set forth:

First, the Commission must determine the economic cost of access charges through a study it would complete this year. This study would then serve as the benchmark for comparison with LEC access reductions. The Commission would mandate the appropriate reduction each year.

Starting July 1, 1998, the Commission would assess whether there has been the movement toward TELRIC rates that would be expected if access charges were to reach cost by July 1, 2002. If the reduction were less than the linear reduction expected each year, a prescriptive reduction would be ordered.

Second, it is critical that the FCC enforce the mechanisms necessary to permit vibrant market operation. Thus, failure of an ILEC to meet the performance standards, service quality measurements, and other terms and conditions governing access to unbundled network elements, including collocation and access to fully operational support systems, as set forth in its Section 252 agreements, should result in a suspension of the flat fees created by the access restructuring order in the geographic area governed by the agreements until such a time as the ILEC requirements were met. The flat fees would contain, by definition, surplus funds that cannot be justified by the cost of access or the needs of the universal service fund.

This additional trigger would serve to remind the ILECs that failure to provide OSS and other market-opening requirements immediately limit their recovery of access revenues. Absent such a method, use of a market-based approach would fail to create any incentives for ILEC actions to open the local market.

Use of these triggers would be consistent with the recent proposals by the Department of Justice and the NTIA, both of which urged the use of a prescriptive approach if access rates were not reduced by competition. As these two agencies recognized, the development and strength of competition as a means of ensuring access reductions is, at best, unclear. Thus, the Commission must adopt a mandatory approach to reduce access charges to protect ratepayers. Use of the triggers outlined above would help provide ratepayers the protection they need to achieve access rate reductions.

III. <u>How may the FCC move quickly to ensure the neutrality and portability of universal service support?</u>

The Commission can move quickly to ensure the neutrality and portability of universal service support by moving funds identified in this proceeding as providing universal service support into a competitively neutral and explicit federal fund, until support can be determined based on a forward-looking cost proxy model. Section 254(b)(4) and (5) of the Telecommunications Act of 1996 ("Act") require it, and it is easily accomplished.

Based on the record in this proceeding, at least $5.7 billion in existing mechanisms fund universal service. There is no dispute that the current Universal Service Fund (high cost assistance fund), triple DEM weighting, and Long Term Support, which total approximately $1.51 billion annually, fund universal service. In addition, approximately $180 million is collected annually to fund Lifeline and Link-Up for low income consumers. All of these programs should and can be funded through the new and explicit federal universal service fund.

The record also supports a finding that a portion of access charges, in addition to Long Term Support, represents implicit funding for universal service. For example, in a joint filing, BellSouth Corporation, Pacific Telesis Group and SBC Telecommunications state that $4 billion in implicit universal service support is currently contained in switched access charges.[4] Thus, this $4 billion may be immediately removed from access charges and "replaced" by an interim $4 billion universal service fund, to operate until a final judgment on the size of universal service is made and all universal service subsidies are removed from access charges. Failure to make explicit those sums that are now recognized to constitute universal service support would violate the Act and would deprive new entrants providing service to a ratepayer eligible for universal service of the support that Congress intended to be immediately available.

Sincerely,

Jonathan B. Sallet
Chief Policy Counsel

Attachments

cc:

Commissioner Chong	Larry Atlas
Commissioner Ness	Richard Metzger
Commissioner Quello	John Nakahata
Regina Keeney	Kathy Levitz
William Kennard	Suzanne Tetreault
Greg Rosston	

[4] See, Ex Parte Letter dated April 15, 1997 to The Honorable Reed E. Hundt from David J. Markey of BellSouth Corporation, Thomas O. Moulton, Jr. of Pacific Telesis Group and Dale "Zeke" Robertson of SBC Telecommunications, Inc. at 3. See also, Ex Parte letter dated April 16, 1997 to the Honorable Reed E. Hundt from Bruce K. Posey of US West, Inc., at 2.

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Bradley C. Stillman
Senior Counsel
Federal Law and Public Policy

EX PARTE

April 23, 1997

William F. Caton
Acting Secretary
Federal Communications Commission
Washington, DC 20054

Re: Ex Parte Submission
CC Docket No. 96-262

Dear Mr. Caton

In response to a staff request, MCI submits the attached material, which outlines the mechanisms the Commission can use to bring down access rates which are currently in this record. Please associate it with the record in the above captioned docket.

Respectfully submitted,

Bradley C. Stillman
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CC: Larry Atlas
Tom Boasberg
James Casserly
James Coltharp
Dan Gonzalez

How the FCC Can Reduce Access Rates Based on the Current Record

Reinitialize the price cap to 11.25% or 10%

- Approximately $2 billion reduction if price cap is reset to 11.25%, about $2.7 billion if set at 10%

There is precedent to reinitialize rates both from the original price cap when the authorized ROR was lowered to 11.25%, and from language in that decision that one of the things the Commission would review when evaluating whether the price cap is operating properly is earnings. The most recent earnings numbers, which average about 15% would indicate that the current cap is not yielding appropriate rates, either because it was set wrong initially, the FCC underestimated the productivity of the LECs or a combination of both. An e parte submission filed April 18, 1997 which includes an evaluation of achieved LEC productiv under the interim price cap plan is attached.

There is also evidence on the record that the cost of capital has declined since the price cap was changed. Initially, LECs claimed it was temporary and could not be sustained, so the Commission should ignore it. However, the cost of capital has remained steady at about 10% over a decade. At least one state, Washington, has recognized this to be the case for intrastate services and has reduced the authorized rate of return to 9.6%. The same method used by the Commission to calculate the 11.25% ROR in the original price cap decision would today yielc return closer to 10%. In light of the fundamental changes brought on by the 1996 Act and the growing earnings of the price cap companies, significant changes to the LEC price cap are appropriate. Indeed, one of the reason's for reinitialization at the time the price cap was creat was that it represented a fundamental change in the regulatory environment.

Legal precedent clearly states that the Commission when, "faced with new developme or in light of reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrative rulings and practice." American Trucking Ass v. Atchison, Topeka, and Santa Fe Ry. Co., 387 U.S. 367, 416 (1967). Furthermore, as long a the Commission supplies a reasoned explanation, it has the authority to adapt rules and polici as circumstances change. Motor Vehicle Manuf. Ass'n. v. State Farm Mut. Automobile Ins. (463 U.S. 29, 42 (1983). The full memo on this issue was filed as an ex parte on April 7, 1997 and is attached.

Increase Productivity Adjustment

- $210 million reduction per percentage point increase.

The productivity adjustment is supposed to be an incentive to the LECs to become m efficient. The current price cap, with its low productivity adjustments, provides no challenge increased LEC efficiency. Studies were placed in the price cap docket by AT&T, AD HOC a CARE which indicate true LEC productivity is as much as 10%. In addition, after the interin order was issued, additional analysis submitted by CARE was done using LEC earnings to sh what level of productivity a price cap LEC would need to have made to choose a 5.3% productivity factor without sharing. The continuing trend of increased earnings would indicate that even with the modest increases in X factor in the interim order, the price cap is not properl calibrated to yield a reasonable profit or emulate the competitive market.

MCI recently filed an analysis of LEC earnings as an ex parte at your request which indicates the appropriate productivity adjustment would fall between 7.95% and 10.63%. This LEC productivity analysis is filed in response to a flawed analysis submitted by USTA in attachment 7 of its access reform comments which purports to show unbelievably low LEC productivity.

Eliminate the TIC

- $2.8 billion

Based on the remand decision in the Comptel case, the FCC must show that there is an economic basis for the TIC or eliminate it. MCI and others have long maintained there is no economic basis for the TIC, including in our access comments and, a review by the Commissio will bear this out. The fact that both NYNEX and Bell Atlantic admit as part of their access pl from AT&T that at least 80% of the TIC cannot be defended as cost based gives the Commissi additional record basis to eliminate or virtually eliminate the charge altogether.

Reduce Terminating Access

- $3.8 billion in access reductions if reduced to 1.1 cents . (Both originating and terminating yields $6.5 billion)

A review of ex parte filings by the RBOCs and GTE reveals that incumbents maintain t embedded cost of interstate switched is about $0.011 per minute on each end. While record evidence from the Hatfield model shows the economic cost at less than half of a cent, the Commission can rely on the LEC data to reduce current rates from $0.027 per minute to the le identified by the LECs until a full TELRIC study is complete and rates can be brought down th rest of the way. While there is disagreement about whether originating access is subject to competition, the record is also full of cites indicating that virtually all parties agree that terminating access is a bottleneck under any view. This only strengthens the argument for the Commission to reduce terminating access rates at least down to the level identified by the LEC

Move Legitimate Universal Service Subsidies Out of Access

- At least $1.6 billion in access reductions would be achieved by moving interstate universal service monies to an explicit USF as required by the 1996 Act.

While there continues to be significant differences of opinion about the exact size of th USF, all parties agree that the need will be at least the $6.6 billion ($1.6 billion = 25%) identif by the Hatfield model. Therefore, the Commission should order the interstate share of those funds moved from the current access charge regime, which is being used in part to subsidize universal service, into the explicit universal service fund. In addition, the Commission must ta the $400 million in LTS and more than $300 million from triple DEM weighting out of the per minute access charges and placed into the new USF. As we noted in our letter to the Commission on March 28, 1997, MCI would not change the amount of universal service fundi for non-price cap LECs. Rather, we believe these programs should be moved at their fully funded levels into the new USF. This will encourage greater competition by permitting competitors entering smaller markets to obtain universal service funds when serving rural customers.

There can be no doubt that today's access charges, which all admit are far above cost, a being used to subsidize universal service. (See e.g., In the Matter of Access Charge Reform CC Docket No. 96-262, Notice at para. 40; USTA Comments at 3; MCI Comments at 8; Implementation of Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order at para. 717.) Since the removal of the universal service dollars from access charges does not bring access rates below the $0.011 per minute which the LECs claim as their actual cost in the record, the ILECs will not even be able to make a credible takings argument. MCI, of course, believes the Commission should adopt TELRIC rates for access which cannot a taking because it includes a reasonable profit.

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EX PARTE

April 18, 1997

William F. Caton
Acting Secretary
Federal Communications Commission
Washington, D.C. 20554

Re: *Ex Parte* Submission
CC Docket No. 94-1 and 96-262

Dear Mr. Caton:

In response to a staff request, MCI submits the attached material, w computes the LECs' projected and achieved productivity based on their performance under the interim price cap plan. Please associate it with th record in the above captioned dockets.

Respectfully submitted,

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MCI Telecommunications Corp.
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CC: Anthony Bush, James Casserly, James Coltharp, Tom Boasberg, Dan Gonzales, John Nakahata, Greg Rosston

In Attachment 7 of its comments in CC Docket 96-262, filed Janu 1997, USTA purports to correct an analysis of local exchange carrier (L productivity previously filed by MCI. These "corrections," claims USTA, that the LECs' productivity was only 2.85%. However, USTA's analysis flawed. As described below and in the attached tables, the LECs' choic productivity factor under the interim price cap plan and their achieved e since 1995 indicate that their own assessment of prospective productivi been between 7.95% and 10.63%. MCI urges the Commission to set th productivity factor within that range.

MCI's initial analysis examined the LECs' choice of productivity f two times. First, it examined the choice of 5.3% in 1995, when the inter cap plan was adopted. The LECs' choice of 5.3% at that time implied tl LECs expected to achieve productivity of at least 8.54%. Second, the a examined the LECs' choice of 3.3% as their productivity factor under th LEC price cap plan, and found that they would have chosen this produc factor so long as their expected productivity were no more than 10.86%

USTA claims that this analysis by MCI is in error because it assu the LECs were earning 11.25% when they made their productivity elect 1995. Since the LECs' earnings were in fact 13.78% in 1994, USTA cl LECs could have been expecting lower productivity than MCI's analysis and still have chosen an X of 5.3%. In fact, USTA states, duplicating M original analysis but starting from a rate of return of 13.78% results in a even X factor of only 2.85%.

USTA's criticism, while making a valid point, is flawed. First, US criticism does not apply to the analysis of the original price cap plan, si starting point rates under price caps were adjusted to target an 11.25% return. Thus, the LECs' choice of 3.3% in the initial price cap filing ind the LECs' expected productivity was no more than 10.86%, as MCI's or analysis showed. Second, while the LECs' rate of return in 1994 is rel what their expected productivity level was, USTA has misapplied their in its analysis.

The 13.78% rate of return that the LECs achieved in 1994 is no correct starting point for the analysis. The Commission required the L take two exogenous adjustments to their price caps, which lowered the revenues without changing their costs. These two changes, removal c Post-Employment Benefits and adjusting the cap by 0.7 percentage pc each year the LECs chose a productivity factor of 3.3% under the origi cap plan, lowered the LECs "starting-point" earnings to 11.64%. Give earnings, the LECs' projected X factor in 1995 would have to have bee 7.95%, as shown in Table 1. In fact, since the LECs achieved earning 13.88% in 1995, their achieved productivity was 10.63%, as shown in

This productivity continued into 1996 when the LECs earned 14.9ε Given their 1995 and 1996 earnings, the LECs must have achieved produ of 7.93% in 1996, as shown in Table 2. Clearly, the LECs' achieved prod under the interim price cap plan when they have had the greatest incenti control their costs, has been between 8% and 10%. This is consistent wi election of productivity factor under the original price cap plan, as discuss above. MCI urges the Commission to set the X factor at a level which wi the achieved productivity levels of the LECs.

TABLE 1

1994 Price Cap Revenue ($000)	$ 21,618,490	
Net Investment ($000)	$ 30,828,507	
Composite Income Tax Rate	40.00%	
1994 Reported ROR	13.78%	
1994 Reported ROR, adj for OPEB, X-factor adjustment	11.64%	
50/50 Sharing @	12.25%	12.25%
100% Sharing @	13.25%	16.25%

Implicit X	ROR at X = 4%, no sharing	ROR at X = 4%, after sharing	ROR at X = 4.7%, after sharing	ROR a X = 5.3
3.08%	11.25%	11.25%	10.96%	10.
4.26%	11.75%	11.75%	11.46%	11.
5.45%	12.25%	12.25%	11.96%	11.
6.64%	12.75%	12.50%	12.35%	12.
7.83%	13.25%	12.75%	12.60%	12.
7.95%	**13.30%**	**12.75%**	**12.63%**	**12.**
9.02%	13.75%	12.75%	12.85%	13.
10.21%	14.25%	12.75%	13.10%	13.
10.63%	**14.43%**	**12.75%**	**13.19%**	**13.**
11.39%	14.75%	12.75%	13.35%	14.
12.58%	15.25%	12.75%	13.60%	14.
13.77%	15.75%	12.75%	13.85%	15.
14.96%	16.25%	12.75%	14.10%	15.
16.15%	16.75%	12.75%	14.25%	16.
17.34%	17.25%	12.75%	14.25%	16.

TABLE 2

1995 Price Cap Revenue ($000)	$ 22,110,717	
Net Investment ($000)	$ 32,046,559	
Composite Income Tax Rate	40.00%	
1995 Reported ROR	13.88%	
1995 Reported ROR	13.88%	
50/50 Sharing @	12.25%	12.25%
100% Sharing @	13.25%	16.25%

Implicit X	ROR at X = 4%, no sharing	ROR at X = 4%, after sharing	ROR at X = 4.7%, after sharing	ROR X = 5.
-2.35%	11.25%	11.25%	10.96%	10
-1.15%	11.75%	11.75%	11.46%	11
0.06%	12.25%	12.25%	11.96%	11
1.27%	12.75%	12.50%	12.36%	12
2.48%	13.25%	12.75%	12.61%	12
2.60%	**13.30%**	**12.75%**	**12.63%**	**12**
3.69%	13.75%	12.75%	12.86%	13
4.89%	14.25%	12.75%	13.11%	13
6.10%	14.75%	12.75%	13.36%	14
7.31%	15.25%	12.75%	13.61%	14
7.96%	**15.52%**	**12.75%**	**13.74%**	**14**
8.52%	15.75%	12.75%	13.86%	15
9.73%	16.25%	12.75%	14.11%	15
10.93%	16.75%	12.75%	14.25%	16
12.14%	17.25%	12.75%	14.25%	16

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A CHANGE TO ACCESS CHARGES BASED ON FORWARD-LOOKING COSTS IS FULLY AUTHORIZED UNDER THE ACT AND WOULD BE AN ENTIRELY REASONABLE EXERCISE OF THE COMMISSION'S DISCRETION

The Communications Act Does Not Mandate Traditional Rate-of-Return Methods of Rate-Setting.

As the price-cap regulations illustrate, the Commission has ample authority under section 201 of the Act to depart from rate-setting methodologies that provide a rate of return based on historical costs. In fact, the "just and reasonable" standard in section 201 is no more demanding than the constitutional "just and reasonable" test, which plainly permits rate-setting based on present market value and/or forward-looking costs.

An Historical Practice of Using One Rate-Setting Methodology Does Not Preclude Adoption of a New One, Where There is a Rational Explanation for Such a Change.

The fact that the Commission had an existing practice of basing access charges on historical costs does not mean that it would be "arbitrary, capricious or an abuse of discretion" to change course. A regulatory agency, "faced with new developments or in light of reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrate rulings and practice." American Trucking Ass'ns v. Atchison, Topeka, and Santa Fe Ry. Co., 387 U.S. 367, 416 (1967). As long as it supplies a reasoned explanation, "an agency must be given ample latitude to 'adapt [its] rules and policies to the demands of changing circumstances.'" Motor Vehicle Manuf. Ass'n v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 42 (1983) (quoting Permian Basin Area Rate Cases, 390 U.S. 747, 784 (1968)).

The ILECs Cannot Claim that They Received Some Sort of Unspoken Promise that Rate-of-Return Rate-Setting Would Continue Forever.

There is no basis for the suggestion that regulators made some sort of "compact" with the ILECs, guaranteeing permanent rate-setting based on historical costs. The law has for many decades authorized regulators to change to other methods. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). And by imposing price caps, the Commission has already largely abandoned historical cost as the basis of regulation.

Changed Circumstances Fully Justify a Change to Access Charges Based on Forward-Looking Costs.

The 1996 Telecommunications Act virtually compels a move in the direction of access charges based on forward-looking costs. The Act has opened up local markets, including the market in exchange access, to competition. When that policy succeeds, ILECs will have no choice but to price access based on forward-looking costs. But the move toward competition cannot succeed as long as the ILECs are receiving a huge subsidy in the form of inflated access charges because the ILECs will be able to build an anti-competitive war chest. These unwarranted subsidies can be used by ILECs to solidify their hold on their local monopoly markets.

Moreover, the 1996 Act has also opened up long distance to competition from the RBOCs. In order to prevent unfair competition in this market, it is essential that the RBOCs not be allowed to charge higher access charges to competitors than they will incur in providing access to themselves or an anti-competitive price squeeze is inevitable. This is especially the case if terminating access, which is not subject to competitive market pressures, remains above cost. Furthermore, the provision of an integrated local and long distance product will make identification of cross-subsidy and predatory activities far more difficult to discover. Finally, the 1996 Act requires the elimination of implicit subsidies. Thus, the goal of "universal service" can no longer be used to justify bloated access charges.

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BASING INTERSTATE ACCESS CHARGES ON THE FORWARD-LOOKING COST OF PROVIDING THAT SERVICE WOULD NOT CONSTITUTE A "TAKING"

It is spurious to suggest that it would constitute a "taking" under the Fifth Amendment[1] to require ILECs to sell access to IXCs at rates based on forward-looking economic cost. The Commission itself so recognized in requiring ILECs to provide essentially the same service to local competitors at prices based on the forward-looking cost of each element of service ("TELRIC").[2] Under settled Takings jurisprudence, that conclusion was both correct and fully applicable to the issue of interstate access charges.

The Constitution Does Not Require Access Charges Based on Historical Costs.

Agencies are "not bound to the use of any single formula or combination of formulae in determining rates." Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). A past practice of rate-setting based on historical costs does not bar a change to a new system. See, e.g., Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989); Wisconsin v. Federal Power Commission, 373 U.S. 294 (1963). Nor do utilities have a right to the maintenance of a particular overall level of return. The mere "fact that the value [of the utility's property] is reduced does not mean that the [rate] regulation is invalid." Hope, 320 U.S. at 601.

The Only Constitutional Question is Whether the Overall Rate Structure Jeopardizes the Regulated Utility's Financial Integrity.

Because, as the Hope Court noted, "the rate-making process . . . i.e., the fixing of 'just and reasonable'

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[1] U.S. Const. amend. V ("nor shall private property be taken for public use, without just compensation").

[2] First Report and Order, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, ¶ 736 (August 8, 1996).

rates, involves a balancing of the investor and the consumer interests," id. at 603, regulators have a broad "zone of reasonableness" in setting rates. E.g., In re Permian Basin Area Rate Cases, 390 U.S. 747, 770 (1968). The Constitution only bars overall rates that are so low as to "jeopardize the financial integrity of the [regulated] companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." Duquesne, 488 U.S. at 312 (emphasis added); see also Federal Power Commission v. Texaco, Inc., 417 U.S. 380, 391-92 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level."); Permian Basin, 390 U.S. at 769 ("Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness.").

Rates Based on the Current Economic Cost of Providing a Service, including a Reasonable Return, Cannot, in Principle, Violate the Constitution.

Requiring access charges based on economic cost, including a reasonable return, cannot be unconstitutional. Such rates would allow ILECs to earn a reasonable return on the current market value of the assets being used to provide access. That is all that they could expect to earn in a competitive marketplace. In a period of transition to competition, the Constitution cannot be violated by a rate methodology that "mimics the operation of the competitive market" and "gives utilities strong incentive to manage their affairs well and to provide efficient services to the public." Duquesne, 488 U.S. at 318-19.

Rates Do Not Become Unconstitutional Because They Require a Company to Write Off Some of its Prior Investments, Even if those Investments Were "Prudent" When Made.

Access charges based on the current costs of providing access services would not provide ILECs with a guaranteed return on past investments in assets that now constitute excess capacity or use expensive, outmoded technology. But that is not required. Duquesne, 488 U.S. at 315-16; Market Street Ry. v. Railroad Comm'n, 324 U.S. 548, 562 (1945). If that were the constitutional requirement, it would be unconstitutional to subject a formerly regulated monopoly to competition. Thus, in Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993), the court rejected a Takings challenge to a rate order that served to "exclude part of [an] original investment from the rate base." Id. at 1263. Noting that the Commission has no obligation "to include in the rate base all actual costs for investments prudent when made," the court squarely held that, even if the exclusion resulted in a loss of revenues, "there simply has been no demonstration that the FCC's rate base policy threatens the financial integrity of [ILECs] or otherwise impedes their ability to attract capital." Id. Nor could such a showing be made here.

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Access Charge Reform, CC Docket No. 96-262, et al.

Dear Chairman Hundt:

I am writing to express the views of the National Telecommunications and Information Administration (NTIA) on the Notice of Proposed Rulemaking (Notice) in the above-captioned proceeding.(1) The Commission proposes to reform interstate access charges for incumbent local exchange carriers (ILECs) subject to price cap regulation.(2) The proceeding raises a welter of difficult and contentious issues that the Commission and other stakeholders have worked diligently and in good faith to resolve. A number of access reform plans are now on the record that merit careful study and fair consideration. NTIA wishes to contribute to that dialogue in the hope that we can help forge a new access charge regime that fosters local and long distance competition, promotes efficient investment in the nation's telecommunications infrastructure and, most importantly, protects customers from sharp and sudden rate increases.(3)

INTRODUCTION AND SUMMARY

NTIA's views on access reform are guided by four fundamental principles:

First, and foremost, reform should produce noticeable net benefits for the ultimate users of the telephone network -- residential and business ratepayers, especially low-volume long distance users.(4)

Second, as the Commission and many commenters agree, the rate structure for access services or access elements must reflect the manner in which underlying costs are incurred. As the Commission recognizes failing to align prices with relevant costs in this fashion will tend to distort demand for access services, favor some users over others, and deter efficient entry in some instances, while inviting inefficient entry in others.(5)

Third, the Commission's new access charge regime must promote efficient network investments by ILECs and encourage efficient facilities-based entry by new service providers. The former is important because the ILECs' networks are and will remain a critical component of the National Information Infrastructure (NII) for the foreseeable future. If those networks are not sufficiently advanced and reliable, the promise of the NII will be too slowly realized. Increased facilities-based competition is essential to creating the marketplace forces that are the most reliable guarantors of reasonable access rates.

Fourth, access charge reform should move towards minimizing government intervention in the marketplace to avoid market distortions that can result from unnecessary or improvident regulation.

NTIA believes these goals can best be attained through an approach that incorporates aspects of the Notice and the stakeholder plans on the record. We agree, first, that interstate access rates should be restructured to ensure that underlying costs are recovered in an economically rational fashion. Second, we endorse an immediate reduction in interstate access rates through modifications in the existing price cap plan. In the Notice, the Commission has solicited comments on a number of possible changes in the current price cap plan, such as an increase in the applicable productivity factor.(6) NTIA believes that th record amassed in this proceeding is sufficient to justify alterations in the existing price cap plan that would effect a substantial reduction in interstate access rates. If the Commission should decide that further proceedings would be needed before making any such changes, it should conduct and complete those proceedings expeditiously. Furthermore, the Commission should consider postponing the effectiv date of any restructuring in access charges until completion of those further proceedings.

Any rate reduction should be targeted towards reducing common line costs and phasing out the carrier common line charge (CCLC). The Commission must also ensure that any reductions in access rates are passed through to long distance ratepayers, particularly those basic schedule ratepayers that historically have not benefitted from such reductions.

NTIA also favors a market-based approach to drive access rates down in future years. Under that approach, ILECs should have some reasonable, but limited, flexibility to reduce their access rates in response to competitive developments. We therefore recommend that the Commission immediately commence a proceeding to determine the conditions for such flexibility. Continuation of any market-based approach past January 1, 1998, however, must be contingent upon the ILECs' full compliance with their obligations under the 1996 Act to interconnect with competing providers or to provide them with operational unbundled network elements on just, reasonable, and nondiscriminatory terms. If ILECs fulfill those obligations, the Commission could afford them an additional degree of pricing flexibility. If they do not, we urge that the Commission immediately prescribe further reductions in access rates in accordance with any methodology it deems appropriate.

DISCUSSION

A. Rate Structure Issues

The Commission is correct that altering the structure of interstate access charges "is a necessary first step in the new procompetitive era."(7) As the Commission points out, the principal problem with the current rate structure is that it compels ILECs to price access services in a way that does not reflect the way in which underlying costs are incurred.(8) In particular, certain non-traffic-sensitive (NTS) costs are currently recovered through usage-based charges, which distort demand for access services and also encourage uneconomic bypass of ILECs' local exchange networks. As a general proposition, NTIA believes that the existing access charge rate structure should be modified to effect economically rational recovery of NTS costs. In particular, we believe that the following charges need to be examined:

1. Common Line Charges

When the Commission created interstate access charges more than a decade ago, it found that the costs of the loop facilities from the ILEC switching office to the subscriber's premises were NTS in nature. It concluded further that the interstate portion of those costs would be recovered most efficiently by means of a flat-rate subscriber line charge (SLC) paid by each subscriber.(9) Ultimately, however, the Commission elected to recover only a portion of interstate loop costs through the SLC, with the remainder being recovered via a per-minute CCLC payable by all interstate interexchange carriers.(10)

Because of the economic distortions created by the CCLC, NTIA recommends that it should be phased-out. The first step would be to remove from the interstate portion of the ILECs' subscriber loop costs all costs that will be recovered through the new universal service mandated by the 1996 Act. This reduction will both prevent duplicate recovery of such costs by ILECs and permit a corresponding decrease in the CCLC.

Second, and as noted above, the current price cap plan should be modified so as to implement a "down payment" within the context of the price cap record on future access rate reductions applied to eliminate all remaining common line costs currently recovered by the CCLC. If that down payment exceeds remaining CCLC costs, the excess should be used to reduce proportionately SLCs for all customers.

We have some questions about the Commission's proposal to lift the cap on the SLC for multi-line business customers, for second and additional lines to an individual's primary residence, and for all lines to non-primary residences.(11) Before lifting any existing SLC cap, the Commission should first investigate the effect of such an SLC increase on the market for and cost of additional telephone lines.

it determines that a one-time SLC increase would sharply impede the market for additional lines, the Commission should consider phasing-in an increase in the SLC cap over several years.[12] Under no conditions, however, should any SLC exceed the relevant per-line loop costs assigned to the interstate jurisdiction.

Finally, the Commission should modify the way in which it applies SLCs to ISDN services. Rather than assessing a SLC on each derived ISDN channel, the Commission should consider, as some parties suggest, computing ISDN SLCs based on the relative costs of providing ISDN services compared to corresponding standard analog services.[13] Any additional revenues generated by these changes should be used to reduce dollar-for-dollar the CCLC.

2. Local Switching

The Commission suggests that certain components of local switching, such as line cards, are not traffic-sensitive and tentatively concludes that it should recover those costs through flat-rate charges. Further, it suggests that a combination of flat-rate and usage-based charges may best reflect economic costs. Consistent with the principle of moving toward efficient recovery of costs, NTIA supports the development of a local switching rate structure that mirrors the way in which those costs are incurred.

3. Transport

NTIA generally supports the Commission's proposal to reform the rate structure for transport services. Specifically, we agree that the Commission should continue to mandate flat-rate charges (1) for entrance facilities connecting an interexchange carrier's point of presence to the ILEC's serving wire center (SWC)[14] and (2) for dedicated transmission facilities between the SWC and individual ILEC end offices.[15] With respect to tandem-switched transport services, NTIA recommends that the Commission require a flat-rate charge for circuits between the SWC and the tandem switch, which typically are dedicated to a single interexchange carrier (IXC), and a usage-based charge for the shared facilities connecting the tandem switch to the ILEC end office.[16] Finally, to the extent that some costs of the tandem switch itself do not vary with usage, they should be recovered through a flat-rate charge, as is th case with end office switching.[17] The remaining tandem switching costs should be recovered through usage sensitive rates. All of the foregoing charges would, of course, be assessed on IXCs, rather than en users.

NTIA also favors elimination of the per-minute transport interconnection charge (TIC), if not immediately, over a period not to exceed three years.[18] As the Commission recognizes, because the TIC artificially increases the price of switched access minutes, it suppresses demand for interstate services and encourages inefficient bypass of the public switched network.[19] It may also give ILECs a competitive advantage in the provision of interstate transport services.[20]

We believe that the TIC can be reduced expeditiously by first reallocating network costs currently recovered via the TIC to other access elements, and readjusting those rates accordingly. Some of those costs can easily be identified and redirected (e.g., tandem switching costs that the Commission arbitrarily shifted from the tandem switching rates to the TIC; certain SS7 signalling costs could be transferred from the TIC to a signalling rate element).[21] Additionally, ILECs have made colorable claims that certain costs now recovered via the TIC should be reassigned to other rate elements.[22] If those ILECs can convincingly demonstrate that such costs should be recovered through specified rate elements, the Commission should permit their recovery. Finally, to the extent that the TIC recovers cos that the current separations procedures have misallocated to the interstate jurisdiction, separations changes would be appropriate during the transition period to permit complete elimination of the TIC by the end of that period.

B. Access Rate Levels

Many observers sense that existing access rates are too high, although there is no agreement about the magnitude of that excess, the reasons for it, and the proper response to it.(23) The Commission requests comment on two alternative means of achieving reasonable interstate access charges. The first -- a "market-based" approach -- would rely on steadily strengthening "marketplace forces to move interstate access prices to more economically efficient levels" over time.(24) The second is a "rate prescription," under which the Commission "would move access rates to forward-looking economic costs in a . . . predictable and uniform manner."(25)

NTIA shares the Commission's goal of reasonable interstate access rates.(26) Available TSLRIC cost studies suggest that there is a large gap between current access rates and the costs of providing access services.(27) Those studies reinforce experience gained from the growth of competition to date, which implies that the ILECs' monopoly local networks also contain a substantial amount of excess costs that should not be recovered through interstate access rates.(28)

For these reasons, NTIA favors an immediate "down payment" within the context of the price cap record from ILECs on future access reductions, in the form of an immediate decrease in their current interstate access rates.(29) The reduction should take place after access rates have been restructured to recover costs more efficiently. NTIA expects, moreover, that in keeping with the public commitment by the major IXCs, all IXCs will pass any reductions in their access charges through to their customers, including their basic schedule tariff customers.

Even after the reduction has been implemented, it is important for the Commission to provide a blueprint for further reductions in access rates.(30) The Commission should, of course, continue its vigorous efforts to foster facilities-based in local telecommunications markets. In addition, NTIA recommends that mechanisms, including implementation of the unbundled network element platform, be put in place immediately to allow marketplace forces to induce future decreases in interstate access rates.

At the same time, ILECs should be afforded some latitude to respond to competitive pressures, but only such license as the degree of market competition warrants. Thus, for example, when ILECs have satisfied their basic obligations under the 1996 Act to interconnect with and offer unbundled network elements to competitors on just, reasonable, and nondiscriminatory terms, they should be given limited downward pricing flexibility. More expansive pricing flexibility should be withheld until ILECs do their parts to ensure that those interconnection and unbundling agreements become the engines for meaningful competition in the local exchange marketplace, as Congress intended. If the Commission, after investigation, determines that the ILECs have not faithfully discharged their obligations under the 1996 Act, it should immediately abandon a marketplace solution to access reform in favor of a prescriptive approach.

In NTIA's view, a "market-based" approach should have the following essential characteristics and safeguards:

1. <u>Pricing Flexibility</u>

The Commission proposes to give individual ILECs a modicum of pricing flexibility when an ILEC "can demonstrate that it faces potential competition for interstate access services in specific geographic areas."(31) NTIA believes that the Commission should afford an ILEC some latitude in reducing access rates when that ILEC confirms that it has negotiated and implemented a State-approved interconnection agreement that satisfies section 271(c)(2) of the Communications Act. The conclusion of such an agreement provides credible evidence that the local exchange market is sufficiently open so that new entrants can begin to offer competing services. An ILEC should therefore have some ability to adjust its rates downward in response to such entry. The Commission should immediately commence a proceedin to consider the scope of and conditions on that flexibility.

2. <u>Protection for Captive Customers</u>

Whatever the degree of latitude that ILECs may be afforded to reduce their rates in the face of